

# **Bank Branch Audit - Advances and NPA**

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# Structure of Presentation

- Setting the Context
- Bank Branch Audit
- Advances
- Non Performing Asset
- Restructuring
- Other Key Aspects



# Setting the Context

# Banking History

Story of banking starts from **Bank of Hindusthan** – 1770 : First bank at **Calcutta** under European Management

Three Presidency banks were set up - **Bank of Calcutta, Bank of Bombay and the Bank of Madras**. These worked as quasi central banks in India for many years

In 1921, these 3 banks merged with each other and Imperial Bank of India got birth. It is today's **State Bank of India**. (name changed in 1955)

**Allahabad Bank** – 1865 : known as India's Oldest Joint Stock Bank

**Punjab National Bank** – 1895 : First bank purely managed by Indian

**Central Bank of India** – 1911 : First Indian commercial bank which was wholly owned and managed by Indians

# Banking Facts

Reserve Bank of India

Schedule Banks

Commercial Bank

Co-op  
Bank (42)

Public Sector  
Bank  
(26)

RRB  
(82)

Foreign  
Bank (43)

Private Sector  
Bank  
(20)

SBI &  
Associate  
(6)

Other  
Nationalise  
Bank  
(20)

# Key characteristics of a Bank

Governed by Banking Regulation Act, 1949 (e.g. Presentation and disclosures (Schedule III))

Regulated by the **Reserve Bank of India** (e.g. Prudential norms etc. )

Key characteristics of a Bank are:

- Acceptance of deposits → commercial lending activity + treasury/ investment activity
- Conduct of business and operations is either centralised at head office and/or decentralised in branches;
- Significant dependence on technology due to very high volumes and high degree of automation of operations



# Key Risk Bank

Risk Category	Key Areas of Focus	
Credit Risk	Risk that a borrower will be unable to meet its obligations	Assessment of recoverability of Advances, Investments, Derivatives and Other Assets
Liquidity Risk	Risk that the bank's obligations to repay liabilities or fund new loans exceeds the banks ability to raise funds from either the liquidation of assets or the acceptance of new deposits	Review of maturity pattern of assets and liabilities

# Key Risk Bank

Risk Category	Key Areas of Focus	
Market Risk	Financial impact on a bank resulting from movements in exchange rates and interest rates	Review of stress testing performed on the portfolio
Regulatory Risk	Non Compliance/violation of Regulations resulting in penalties and fines	Assessment of compliance with Banking Regulation Act, 1949, guidelines and notifications issued by RBI for conduct of operations, accounting of transactions and disclosures
Operation Risk	Banking Operations risk like people risk, IT system risk, Internal process and controls	To review HR policies, IT systems, system audit and review of internal controls



# Banks Financials

	Schedule	31-03-2013	
<b>CAPITAL AND LIABILITIES</b>			
Capital	1	11 00 00	
Reserves and surplus	2	33 00 00	65%
Deposits	3	357 50 00	
Borrowings	4	93 50 00	17%
Other liabilities and provisions	5	55 00 00	
TOTAL		550 00 00	
<b>ASSETS</b>			
Cash and balances with Reserve Bank of India	6	33 00 00	
Balances with banks and money at call and short notice	7	22 00 00	25%
Investments	8	137 50 00	
Advances	9	302 50 00	55%
Fixed assets	10	27 50 00	
Other assets	11	27 50 00	
TOTAL		550 00 00	

# Banking Facts

Public Sector Bank

(Rs in Crore)

Particulars	2008-09	2009-10	2010-11	2011-12	2012-13
No. of banks	27	27	26	26	26
No. of offices	57,979	62,080	65,800	70,969	75,779
Deposits	31,12,747	36,92,019	43,72,449	50,02,013	57,45,697
Advances	22,59,212	27,01,019	33,04,433	38,77,308	44,72,774
CRAR	13.49	13.27	13.08	13.23	12.38
Net NPA ratio	0.94	1.10	1.09	1.53	2.02

Private Bank

(Rs in Crore)

Particulars	2008-09	2009-10	2010-11	2011-12	2012-13
No. of banks	22	22	21	20	20
No. of offices	9,288	10,516	12,097	13,970	16,001
Deposits	7,36,378	8,22,801	10,02,759	11,74,587	13,95,836
Advances	5,75,328	6,32,441	7,97,544	9,66,403	11,43,249
CRAR	15.23	17.43	16.46	16.21	16.84
Net NPA ratio	1.29	1.04	0.56	0.46	0.52

Source - RBI

# Banking Facts - NPAs

## Non Performing Assets

Source – CARE research report

Particulars	Public Sector Banks			Private Sector Banks		
	31.03.12	31.03.13	30.09.13	31.03.12	31.03.13	30.09.13
Gross NPA Ratio	2.98	3.59	4.47	1.96	1.86	1.95
Net NPA / Net Worth	17.5	22.4	29.3	2.7	2.97	3.39
Rest. Advances / Net Advances	6.24	7.05	7.61	2.02	1.71	1.76

Rs in Crore

Year	NPAs in Public Sector Banks
31.03.2008	39,030
31.03.2009	44,954
31.03.2010	59,927
31.03.2011	74,664
31-03-2012	117,000
31-3-2013	1,64,461
31-3-2013 PSBs + Private/Foreign Banks	1,94,000

Source: All India Banks Employees Association circular letter no. 27/42/2013/54 dated December 03, 2013

# Banking Facts – NPAs (PSBs)

(Rs in Crore)

Particulars	Amount
Bad Loans in Public Sector Banks (March 2008)	Rs. 39,000
Bad Loans in Public Sector Banks (March 2013)	Rs. 1,64,000
Bad Loans restructured & shown as good loans	Rs. 3,25,000
Fresh Bad loans in the last 7 years	Rs. 4,95,000
Profits transferred and adjusted for provisions towards bad loans (2008 to 13)	Rs. 1,40,000
Bad Loans in 172 Corporate Accounts (Rs.100 crores and above)	Rs. 37,194
Bad Loans in top 30 bad loan accounts in 25 Public Sector Banks	Rs. 64,000
Bad Loans in 7295 Accounts (Rs. 1 Crore & above)	Rs. 68,262
Bad loans written off in the last 7 years	Rs. 1,40,000

Source: All India Banks Employees Association circular letter no. 27/42/2013/54 dated December 03, 2013

# Banking Facts – NPAs (PSBs)

Rs in Crore

Particulars	Amount
Fresh/new NPAs during 2009-10	44,818
Fresh/new NPAs during 2010-11	58,226
Fresh/new NPAs during 2012-13	92,808
Fresh/new NPAs during 2012-13	1,19,613
Fresh bad loans in the last 4 years	3,15,465

Rs in Crore

Year	Gross profit	NPA provisions	published net profit
2008-09	45,494	11,121	34,373
2009-10	57,293	18,036	39,257
2010-11	74,731	29,830	44,901
2011-12	87,691	38,177	49,514
2012-13	93,684	43,102	50,582
2008 TO 2013	3,58,893	1,40,266	2,18,627
2012-13 (Private Banks )	36,163	7,168	28,995

Source: All India Banks Employees Association circular letter no. 27/42/2013/54 dated December 03, 2013

# Banking Facts – NPAs (PSBs)

## LIST OF TOP 10 BANK LOAN DEFAULTERS IN PUBLIC SECTOR BANKS

(Rs. in Crore)

SN	Borrower	Default Amount
1	KINGFISHER AIRLINES	2,673
2	WINSOME DIAMOND & JEWELLERY CO. LTD.	2,660
3	ELECTROTHERM INDIA LIMITED	2,211
4	ZOOM DEVELOPERS PRIVATE LIMITED	1,810
5	STERLING BIO TECH LIMITED	1,732
6	S. KUMARS NATIONWIDE LIMITED	1,692
7	SURYA VINAYAK INDUSTRIES LTD.	1,446
8	CORPORATE ISPAT ALLOYS LIMITED	1,360
9	FOREVER PRECIOUS JEWELLERY & DIAMONDS	1,254
10	STERLING OIL RESOURCES LTD.	1,197
	Total	18,035

Source: All India Banks Employees Association circular letter no. 27/42/2013/54 dated December 03, 2013



# Banking Facts - Restructuring

Rs in Crore

Particulars	Cases Referred		Cases Rejected		Cases WIP		Cases Approved	
	No	Amount	No	Amount	No	Amount	No	Amount
Dec 2013	605	407,656	105	52,866	57	65,492	443	289,298
March 2013	521	297,990	87	36,894	33	32,083	401	229,013
March 2012	392	206,493	59	20,817	41	35,161	292	150,515
March 2011	305	138,604	42	9,667	21	18,023	242	110,914

Source – cdrindia.org

Rs in Crore

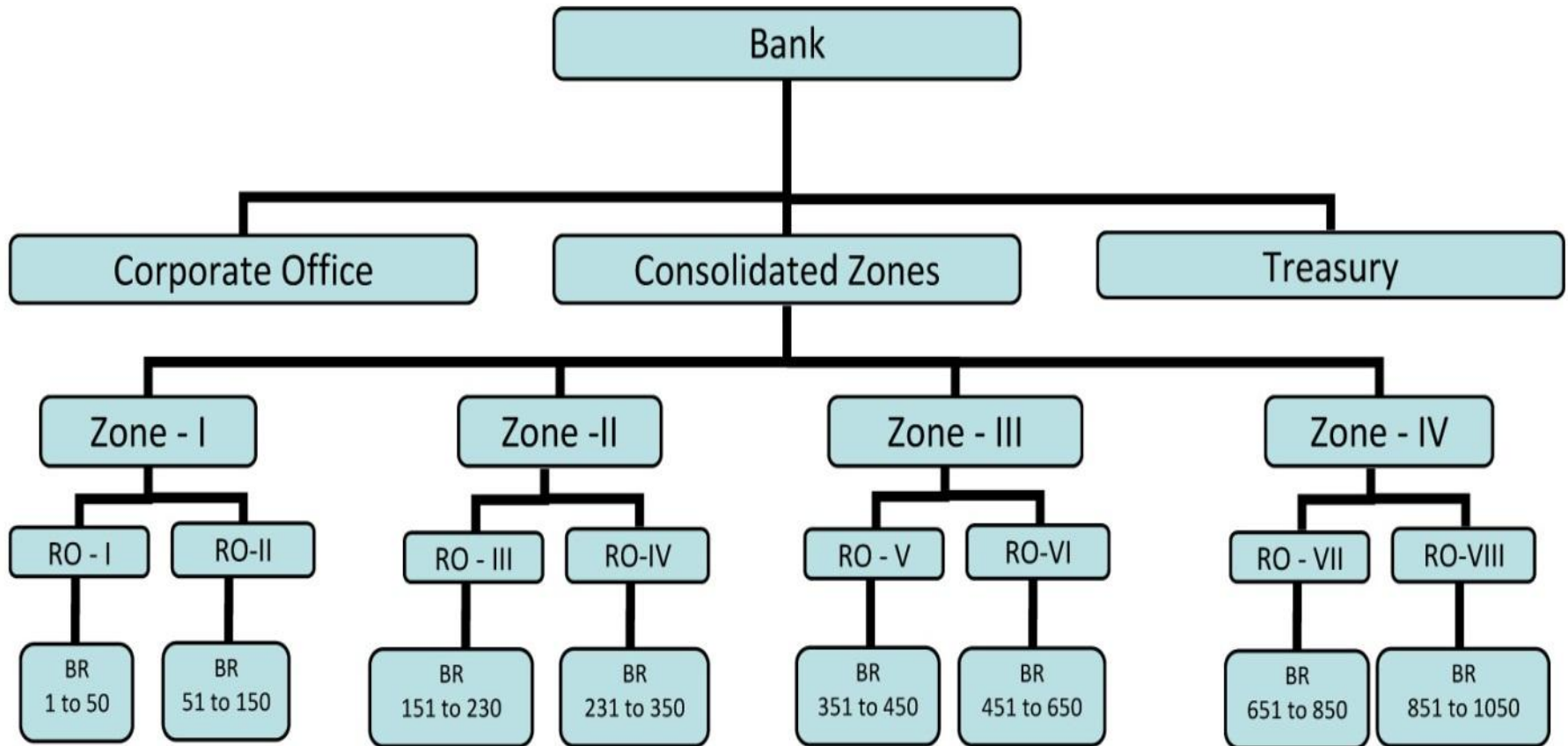
Industry	Amount	(% share)
Infrastructure (including Power)	77,000	36.63
Textiles	19,000	9.24
Iron and Steel	18,000	8.54
Aviation	11,000	5.29
Total	1,25,000	59.71

Source – CARE research report



# Bank Branch Audit

# Banking Structure



RO – Regional Office

BR – Branches

# Bank Audit Process

Branch's financial statement gets consolidated to RO



RO to Zone



Zone to Bank's Financial Statements

While auditing the bank's financial statements, Statutory Central Auditor rely on the Bank's Branch Auditor's report and same fact is also mentioned in the audit report for the Bank as whole

SA 600 – Permits Auditor to rely on work of Component Auditors

**Hence Branch Auditor is Responsible for Financial Statements, RBI Compliances, NPAs, Restructuring of the Branch**

# Key Steps in Branch Audit

- Appointment Formalities – Engagement Letter with Bank Branch, NOC
- Read Circular issued by HO. It covers many important aspects
- Attend Meeting organised by HO. SCAs highlights imp aspects in Meeting
- Planning Meeting with Branch Manager
  - Understand Operations of Branch
  - Meet all operations head and audit co-ordinator
  - Ask for previous year financials, LFAR, CY Internal Audit Report, RBI audit report and any other audit conducted during the year
  - Any major event or changes during the year
  - Any NPA, Restructuring during the year – get brief about same
  - Discussion on sanctioning and monitoring process
  - Brief discussion on IT system and process
  - Internal circulars from Controlling Authority

# Key Steps in Branch Audit

## **RBI Master Circulars and Bank's closing circulars**

Every year on first working day of July month, RBI issues master circular on various aspects like Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances , Deposits, Capital Adequacy, Credit Card Operation, etc. These circulars are extremely important for audit of Bank branch.

## **Deliverables of Bank Branch Auditors**

1. Branch's Balance Sheet
2. Branch's Profit and Loss Account
3. Branch's Audit Report
4. Branch's LFAR
5. Branch's Tax Audit
6. Returns as per closing instructions of Bank
7. Certificates as per closing instructions of the Bank



# Audit Planning

- Internal (Audit Team) and external (with branch management) planning meetings
- Proper audit team needs to be identified
- Day wise allocation and execution of the work is required to be done
- To ensure that proper arrangement is made and access to the IT systems
- Prepare requirement list for the current year audit
- Auditors have to discuss requirement list with Branch manager - obtain agreed timelines for submission of required data.
- Branch audit assignment is always time bound, hence proper planning of assignment helps in concluding assignment in defined time.
- Based on previous year financials (if current year financials is not available) auditors are require to assess the materiality level

# Audit Planning

To understand the functioning of Information system in the Bank and need to find answers for following questions:

- What is **CBS environment**?
- Which **software** is implemented across the bank?
- Whether software is **bought out** or **customised**?
- Whether any steps are necessary to be taken at the branch when software is **modified/updated centrally**?
- Details of **hardware** installed at the branch
- How is **network** managed?
- Details of **other softwares** in the branch ?
- Does the CBS have any **interface** with these software?
- Whether any **system audit** is conducted in the Branch during the year? If **Yes**, What are the **findings**?

# Audit Execution

Auditors need to commence audit before year end i.e. may be a week prior to March 31st.

Key areas to be checked during audit execution are as follows. These have been explained in detail in coming section.

- Deposits and Interest on Deposits
- Advances, NPA, Restructuring and Interest on Advances
- Profit and Loss Account
- Balance Sheet (other items like Fixed Assets, Other Assets, Other Liabilities etc.)
- Surprise Cash and Stationery verification (including ATM if any)
- Penalty imposed by RBI
- LFAR
- Tax Audit of the Branch
- Other Aspects relating to other returns and certificates

# Audit Execution

## Audit of Advances

- Obtain top exposure accounts, New Sanction and Disbursement
- Obtain list of stressed accounts, potential NPAs
- Obtain list of internal restructured accounts
- Obtain list of CDR accounts
- Quick Mortality cases
- Documentation and Provisioning

## Audit of Deposits

- Obtain list of accounts opened and closed during the period
- Obtain list of inoperative accounts
- Verify compliance with KYC norms on test basis

# Audit Execution

## Audit of Deposits

- Review transactions in deposits accounts and compliance with regulatory norms i.e. EEFC accounts
- Verify TDS on interest deposits

## Audit of other items in TB

- Suspense, Inter Branch reconciliation and other reconciliation items
- Provisions other than provisions on Advances

## Ensuring various compliances

- Previous year Audit report, Internal Audit, System Audit
- Compliance to AFI report
- Compliance with HO regulations

# Audit Execution

## Profit and Loss

- Interest Income and Expense recalculation – sample basis
- Checking of interest logic in system and control on data entry
- Yield and Cost analysis
- Checking of other income like locker rent, fee income etc..
- Variance Analysis, Expense Vouching, Provision for Expenses
- Payroll Cost, Depreciation checking

**Small error in logic may have significant impact on Bank as whole**

**Branch Auditor is responsible for all line items of Branch's Financial Statements, hence it is very important to check and get comfort on all line items of Financial Statements.**



A photograph of an airport tarmac taken from an elevated position, likely inside an airport terminal. The tarmac is wet and reflective. In the foreground, there are white painted lines on the asphalt. A large orange banner with the word "Advances" in white text is superimposed over the center of the image. In the background, several aircraft are parked at gates, with ground service equipment like stairs and belt loaders visible. A sign with the number "06" is on the left. An airplane is flying in the sky above the tarmac.

# Advances

# Introduction

- Major Activity of **BANK**
- Largest **ACCOUNT CAPTION** in **ASSETS**
- Major Source of **INCOME**
- Most **FOCUSED** Audit Area – Requires knowledge of overall economy, industry etc..
- Can **SUBSTANTIALLY CHANGE** the financial results
- Time consuming, **AUDIT PLANNING** is essential
- Master Circulars of RBI

# Advances- Bird's eye view

## Loans & Advances



# Types of Advances

## Funded

- Overdraft/Cash Credit
- Term Loans (Project Loans, Home Loans, Vehicle Loans, Mortgage Loans)
- Working Capital Demand Loans
- Bills Purchased/Discounted/  
Foreign Bills for Collection
- Packing Credit
- Foreign Currency Loans

## Non-funded

- Guarantees
- Letter of Credit
- Letter of Comfort
- Co-acceptance of Bills

# Types of Borrowing Arrangements

- Sole Banking
- Consortium Arrangements
- Multiple Banking
- Loan Syndication
- Inter Bank Participation Certificates

# Audit Approach

- Extent would depend on assessment of EFFICACY of internal control
- Examine all large advances i.e. which are lower of following Criteria
  - 5% of Advances
  - Rs.2 crore
- Verify all problematic accounts, potential NPAs
- Verify advances which are adversely commented by/in –
  - Previous Audit Report/ LFAR
  - Internal/ Concurrent Auditors
  - Banks Inspection Report (including RBI Inspection)
  - Report on Verification of Security (Stock Audit, etc.)



# Audit Approach

- Exchange Information report from Consortium/Multiple Bankers
- Any other report related to the particular advance
- Branch Manager's charge handing over report
- Branches control returns to higher authorities concerning overdrawing , adhoc sanctions, Probable NPAs Report, etc
- Verify fresh advances granted during the year (if retail high volume then do sample basis)
- Verify compliance of Restructuring Norms and its asset classification
- Accounts upgraded from NPA to Standard – Full Recovery

# Evaluation of Internal Control

- Existence of clearly laid down **delegation of authority**
- Existence of clearly laid down **eligibility criteria for loans**
- Existence of **system of communicating** the terms of sanction to the borrower
- Existence of **system of execution** of documents before disbursement
- Existence of **system of post disbursement** monitoring and reporting irregularity
- Existence of **system for implementation** of IRAC Norms
- Adequate control on **changing of interest rates, terms and conditions, etc.** in CBS environment

# Major Areas of Considerations



## Pre Sanction

- Application
  - Credit Appraisal
    - Sanctioning/Disbursement
    - Documentation

## Post sanction

- Review/Monitoring
  - Asset classification
  - Provisioning Norms
    - Income Recognition
    - Restructuring

# Application

- Prescribed Application Form
- **KYC compliance** as per RBI Requirements
- **Latest audited financial**, Income Tax Records of Borrower and guarantor
- Review of **Project Report, Projected P&L, BS & Cash Flow**
- **Board Resolution**
- **'No Objection certificate'** from other Banks/ Financial Institution
- Various Registrations/ Licenses/ Permits

# Credit Appraisal

- Appraisal – Defined Standard Format, Competent person
- Review Projections – Realistic
- **CIBIL Report**, Title clearance report & valuation report
- Nature of securities (primary/ collateral) offered and to confirm the adequacy of security cover
- Verify that important financial ratios are satisfactory such as
  - Variation in Sales and Profit after Tax
  - Utilisation of installed capacity
  - Debt Equity ratio
  - Debt service Coverage ratio and other ratios

# Credit Appraisal

- Exposure limit (including derivative instruments) is within the limits fixed by Bank-group wise, Industry wise & policy of Bank
- Prospects of business, sources and periodicity of repayments, evaluation of financial statements, capacity utilization
- Project report- Technical and financial data
- Whether the branch has a policy of maintaining Rejected Proposals
- Whether Branch is conducting credit rating of major advances accounts on periodic basis

# Sanctioning/Disbursement

- Proposal - **appropriate authorisation**
- Recommendations are properly documented and noted
- Limits sanctioned are **within the discretionary** powers of the sanctioning authority
- Pre disbursement unit **inspection** has been carried out & report held on record
- **Adhoc limits (increase)** given to borrower for temporary/ seasonal/ peak periods– whether within the discretionary power, reported to controlling authorities and whether liquidated in time

# Sanctioning/Disbursement

- Verify that disbursement done only after compliance of all terms & conditions of sanction letter
- **Unconditional** Acceptance of the borrower confirming the terms & conditions of sanction is obtained
- Treatment of Creditors for calculation of DP. Based on Sanction
- Verify Margin Money to be brought by borrower
- Verify processing fees and other charges as stipulated is charged



# Documentation

- All loan documents, as required by the sanction letter and loan policy have been executed (e.g. DP Note, loan Agreement, Letter of guarantee, Hypothecation Agreement, etc)
- Loan documents are properly executed and approved by legal expert, if required – whether appropriately **stamped**
- Fresh loan documents are obtained on change in limit, change in the constitution of the borrower
- Original agreement, share certificate, title deeds, title clearance certificate valuation report are held on record
- Documents should not be blank or incomplete & there should be no overwriting, changes, different inks etc.

# Documentation

- Original documents are kept in safe custody
- Charge on securities offered have been registered with registrar of companies/ appropriate authority (RTO, Mortgage Registration)
- In case negative lien is marked in case of property then NOC of housing society should be on record
- Memorandum and Articles of Association or proof of constitution of the borrower
- Special Documentation for Consortium/ Multiple Banking advances
- Verify Documents are not time barred

# Review/Monitoring

- Review/ Renewal of facilities carried out as per the policy of the bank
- Verify Follow up of accounts pending renewal
- Security/ Stock Inspection reports
- Regular Stock & Debtors statements are submitted
- Operation in party accounts – critically review, specially at month end, quarter end (turnover in account, cheques dishonored, Excessive Cash transactions, dormancy of account, balance exceeding limits, transfers from/ to accounts)

# Review/ Monitoring

- Multiple Banking, Consortium – Information and DP allocation
- Fund disbursement has been utilised towards the object for which limit was sanctioned i.e. Not diverted to group companies/ associates or used to pay of existing overdues
- Repayment of existing loan via disbursement of fresh loan
- Periodic review of irregular/ overdue/ NPA accounts has been done at the appropriate level
- Penal interest to be charged if,
  - DP limits breached
  - Statements not submitted

# Review/Monitoring

## Drawing Power Calculation

- Based on Stocks, Debtors and Share value
- Critical review of stock/ Book Debts statement (Old debtors more than 180 days not to be considered)
- DP limits to be set as per latest statements. If stock statements is older than 3 months account to be classified as “irregular”
- Verify banks guidelines for DP calculation specially for unpaid stocks and creditors
- Verify Inventory & equity shares Valuation
- Verify QIS/FFR/Annual Audit Report of the borrower with the monthly stock statement for the last month of the quarter/year
- Verify Stock audit report for NPA's more than Rs. 5 Crore

# Review/Monitoring

## Fraud in Advances

- Sanction without proper application and/or credit appraisal
- Sanction made beyond discretionary power and non-reporting of the same to the appropriate authority
- Unauthorised release of securities
- Security valuation (Especially NPA account e.g. Immovable Assets, Patents)
- Charging of same security to different Banks
- Diversion of funds
- Fraud risk relating to Controls
- Submission of fake transport documents/ godown receipts
- Discounting of accommodation bills/ issuance/ LC
- Circuitous transactions among group companies
- Submission of Stock and Debtors statement directly by borrower to member banks rather than Lead Banker

# Challenges for Auditors

## Information System

Lack of visible evidence

Risk of undetected system errors and bugs

Hidden Frauds in System

Retrieving information and assessing implementation of computer related process

## Application

### Compliances with KYC Norms

Loan sanctioned to a Company which in turn provides finance to individual farmers without ensuring compliance with KYC requirements Auditor should verify KYC documents on test basis

# Challenges for Auditors

## Documentation

### **Consortium Banking: Original Document**

In Case of consortium advances, original documents like Consortium loan agreements, Security Valuation report, etc. are kept by lead bankers

Auditor should ensure copy of all the original documents should be kept by member banks

### **System of Centralised storage/documentation**

Some of the Banks have system of maintaining documents at centralised location

Auditor should ensure to visit that location and verify that documents or get them at the branch



# Challenges for Auditors

## Documentation

### Execution of documents in local language

Some banks execute documents in local language and are not available in English language

Auditor should insist for translation or confirmation of validity of such documents by an expert



# Non Performing Assets

# Asset Classification

## Asset Type

- **STANDARD ASSET / PERFORMING ASSET**  
The account is not a non-performing and does not carry more than the normal risk attached to the business
- **NON-Performing Asset (NPA)**  
The asset ceases to generate income for the bank. (Para 2 of the Master Circular)

# Asset Classification

A non-performing asset (NPA) is a loan or an advance where:

- Interest and/ or installment of principal remain overdue for a period of **more than 90 days** in respect of a term loan
- The bill remains overdue for a period of **more than 90 days** in the case of bills purchased and discounted
- If the Cash Credit/Overdrafts account remains 'Out of Order' as described below
  - F if the outstanding balance remains continuously in excess of the sanctioned limit/ drawing power
  - F No credits in the account for 90 days as at period end.
  - F credits not enough to cover interest debited during the period

# Asset Classification (Cont..d)

A non-performing asset (NPA) is a loan or an advance where:

- Derivatives: Receivables on account of mark to market value remain overdue for more than 90 days

As per para 2.1.3 an account will be NPA only if interest due & charged during a quarter is not serviced fully within 90 days from end of quarter.

- Not to classify NPA merely due to temporary deficiencies but if irregularities continue to classify as NPA
  - (i) Stock statement for calculation of DP is more than 3 months old and such irregularity continues for 90 days
  - (ii) an account where the regular/ ad hoc credit limits have not been reviewed/ renewed within 180 days from the due date/ date of ad-hoc sanction will be treated as NPA.

# Asset Classification (Cont..d)

- NPAs – Borrower-wise and not Facility-wise (To consider all exposure of a borrower including derivatives)
- Verify errors in classification, provisioning/Value of security, interest reversal
- Verify audit trail for changes to critical dates e.g. date of NPA, etc
- Identification of assets as NPAs should be done on an ongoing basis
- Verify if account regularised with only few audits at period ended (source, genuineness, additional audit etc.)

# Asset Classification (Cont..d)

- Make a Detailed **note** on observation and facts especially where you are recommending a change of classification
- In respect of NPAs over Rs.5 Crore, independent valuation
  - Stock audit-Annually
  - Immovable properties-once in 3 years
- Verify that Repayment is from genuine sources
- NPA accounts can be upgraded to performing if all the arrears and principal and not only critical overdues are paid by the borrower
- Suit filled accounts to be classified as Doubtful unless there is strong justification against it
- In case of Consortium advance record of recovery of particular Bank only to be considered.

# Asset Classification

- NPAs are categorized based on the period for which asset has remained nonperforming:

Substandard Assets	which has remained NPA for a period less than or equal to 12 months
Doubtful Assets	if it has remained in the substandard category for a period of 12 months
Loss Assets	identified by the bank or internal/ external auditors or the RBI inspection but the amount has not been written off wholly

- Advances against Term deposits, NSC, KVP, IVP and Life policy not to be treated as NPA provided adequate margins are available

Note- Advances against Gold ornaments and government security and all other securities are not covered in the aforesaid exception



# Asset Classification

## LC Devolvement and BG Invocation

Amount to be added to principal facility i.e. CC account and need to review as per IRAC Norms

LC Devolvement – Rs.20 Cr on 20 Feb 2014

CC Account – DP Rs.120 Cr

## CC Balance

From 01 Jan 2014 to 28 Feb 2014 – Above DP i.e. Rs.125 Cr

From 01 Mar 2014 to 31 Mar 2014 – Below DP but above Rs.110 Cr

- LC Devolvement not o/s more than 90 days – Not NPA
- CC, not over drawn for more than 90 days – Not NAP
- To Add LC devolvement to CC, Combine balance over drawn for more than 90 days - NPA

# Asset Classification

Frauds committed by Borrowers/ Erosion in value of security :  
Where erosion of security is to the extent

- 50% of value as assessed by the bank at the time of last inspection – Doubtful
- 90% of outstanding NPAs – Loss

Doubtful advances guaranteed under ECGC – No provision to be made for guaranteed amount

Example:

Total o/s – Rs.5 Cr, Security – Rs.1.50 Cr, ECGC – 50%

Provision :  $5 \text{ Cr} - 1.50 \text{ Cr} = 3.50 \text{ Cr} @ 50\% = \text{Rs.1.75 Cr}$  plus 40% of secured portion i.e. Rs.0.60 Cr

Hence total provision Rs.2.35 Cr

# Provisioning Norms

- Higher provisioning is warranted if threats to recovery -
- Verify secured and unsecured portion of advances
- Critically verify the value of security as on the balance sheet date
- For accounts classified as doubtful, verify
  - Primary and secondary security charged to the bank
  - Present value through approved valuer (once in 3 Years)
  - Inspection
- In case of Foreign currency denominated Loan Revaluation gain from Foreign exchange fluctuation to be considered as provision against the asset

# Provisioning Norms

Asset Classification	Amount of Provision Required in (%)	
Standard Assets	Advances to Agriculture & SME – 0.25% Advances to Commercial Real Estate (CRE)– 1% Advances to CRE- Residential Housing Loan- 0.75% Other Advances – 0.40%	
Sub-Standard Asset	15 % on total amount and additional 10 % on unsecured portion except infrastructure loan (5% on unsecured portion)	
Doubtful Asset	Secured Portion	Unsecured Portion
Upto 1 Year	25 %	100 %
1 to 3 Year	40 %	100 %
More than 3 year	100 %	100 %
Loss Asset	100 %	

# Provisioning Norms - Updates

- Provision on standrad housing teaser loan @ 2% and 0.40% after 1 year after higher reset of rate
- Restructured accounts classified as standard advances will attract a **provision of 2.75 per cent** in the first two years from the date of restructuring. In cases of moratorium on payment of interest/principal after restructuring, such advances will attract a provision of 2.75 per cent for the period covering moratorium and two years; and
- Restructured accounts classified as non-performing advances, when upgraded to standard category will attract a **provision of 2.75 per cent** in the first year from the date of upgradation

# Provisioning Norms - Updates

- The higher provision on restructured advances would increase from 2.75 percent to 5 percent in respect of new restructured standard accounts w.e.f June 1, 2013 and will increase in phased manner for the stock of restructured accounts as on May 31, 2013
  - 3.50 per cent - with effect from March 31, 2014 (spread over the four quarters of 2013-14)
  - 4.25 per cent - with effect from March 31, 2015 (spread over the four quarters of 2014-15)
  - 5.00 per cent - - with effect from March 31, 2016 (spread over the four quarters of 2015-16)

# Project Loans

- Project Loans means any term loans which has been extended for the purpose of setting up of an economic venture
- For all projects financed by the FIs/ banks after May 28, 2002, the 'Date of Completion' and the 'Date of Commencement of Commercial Operations' (DCCO), of the project should be clearly spelt out at the time of financial closure of the project and the same should be formally documented
- A loan for an infrastructure (infra) project will be classified as NPA if it fails to commence commercial operations **within two years from the original DCCO**, even if it is regular as per record of recovery
- A loan for a non-infrastructure (non-infra) project will be classified as NPA if it fails to commence commercial operations within **one year from the original DCCO**, even if is regular as per record of recovery

# Challenges for Auditors

- Identifying accounts as NPA where inherent weaknesses, solitary credit are observed (Para 4.2.6 of RBI Master Circular on IRAC)
- Identifying erosion in security of NPAs and resultants accelerated provisioning
- Verifying unsecured loans with sanction limit upto 1 crore
- Difficulties in verifying and identifying NPAs specially for the Agricultural Loans and Kisan Credit Card (KCC) Scheme Loans
- Identifying quick mortality cases
- Ensuring genuine transactions in cash credit account



# Challenges for Auditors

- Correctness of Stock and Debtors statements
- Correctness of data input e.g. security valuation, interest rate, penal interest charges, inspection details, etc.
- Divergence of fund and End use of funds
- Running Packing Credit Account:
  - Disbursed amount should be paid within due date as per LOI or purchase order
  - System appropriates the funds as per FIFO basis rather than adjusting against actual Bill receipt
  - Hence, System does not capture the old o/s bills and account never becomes NPA
  - System uses the same logic as that for CC accounts which is incorrect

(E.g. Amount received towards bill o/s for < 180 days gets appropriated towards bill o/s > 180 days)

# Challenges for Auditors- Asset Shortage

- **Asset Shortage** is the shortfall in the value of security as against net outstanding balance, which requires additional provision as per extant norms.
- Additional Provision can be because of Ageing or Asset Shortage
- Manual calculation of Asset shortage can be a challenge
- Non updation/ Wrong updation of security value in the system
- Other Discrepancies
  - Non availability of Lenders' latest dues: consortium/multiple banking
  - Status of unpaid statutory dues not ascertained
  - Latest status required for registration of charges with authorities
  - Older Valuation Reports/ Stock Statements

A close-up photograph of an industrial welding process. Bright sparks are being emitted from the point where a welding torch meets a metal surface. The background is dark and out of focus, showing various industrial components.

# Restructured Advances

# Restructured Loans

RBI master circular dated July 2, 2013 - Prudential Guidelines on Restructuring of Advances

- Restructuring of advances under consortium/ multiple banking/ syndication arrangements - CDR mechanism
- Banks may restructure the accounts classified under 'standard', 'substandard' and 'doubtful' categories – **LOSS can not be restructured**
- Banks can not reschedule / restructure / renegotiate borrowal accounts with retrospective effect

# Restructured Loans

- While a restructuring proposal is under consideration, the usual asset classification norms would continue to apply. The process of reclassification of an asset should not stop merely because restructuring proposal is under consideration
- The asset classification status as on the date of approval of the restructured package by the competent authority would be relevant to decide the asset classification status of the account after restructuring / rescheduling / renegotiation.
- Only loans with Viability and with reasonable certainty of repayment to be Restructured
- Borrowers indulging in frauds and malfeasance will continue to remain ineligible for restructuring,

# Restructured Loans

- BIFR cases are not eligible for restructuring without their express approval
- Standard loan to be classified as Sub-standard after Restructuring
- NPA remains NPA and slip to further lowest asset classification
- All restructured accounts which have been classified as non-performing assets upon restructuring, would be eligible for up-gradation to the 'standard' category after observation of 'satisfactory performance' during the '**specified period**' defined as a period of one year from the commencement of the first payment of interest or principal, whichever is later, on the credit facility with longest period of moratorium under the terms of restructuring package.
- In case of non satisfactory performance, asset classification of the account will be governed as per prudential norms with effect from pre-restructuring payment schedule



# Restructured Loans

- Additional Finance – Standard for one year. If after one year, if restructured is not upgraded to standard, additional to have same classification as original restructured advance
- On subsequent restructuring – standard asset becomes sub-standard. If NPA, subsequently restructured, to be evaluate classification from original date of NPA
- Advances restructured on second or more occasion may be allowed to be upgraded to standard category after the specified period in terms of the current restructuring package, subject to satisfactory performance.
- Recompense (Mandatory in all CDR cases)
  - 100% recompense amount if facility below base rate
  - Atleast 75% recompense amount for other cases

# Bird's eye view- CDR



- Application by the Borrower for restructuring
- Flash Report to be put up to CDR EG within 30 days of receipt for deciding on admission
- Super Majority – 75% by value & 60% by number (approval from internal credit committees)
- Final Restructuring Proposal to be put up to CDR EG by Lead Banker/Monitoring Institution within 90 days / maximum 180 days for approval
- On approval by super majority CDR Cell to issue the Letter of Approval (LOA) to MI / Lenders
- Issue LOI to Borrower for seeking unconditional acceptance
- Lenders to implement the package within 120 days to avail regulatory concession in asset classification (e.g. Promoters contribution, MRA, security documents)
- Monitoring of approved account to be done through Monitoring Committee



# Restructured Loans

## Certain exceptions in circular:

Other than for Capital Market Exposure, Personal / Consumer Loan/ Commercial Real Estate

- Incentive for quick implementation of Restructuring within 120 from the date of receipt of application by the Banks (non CDR) / 120 days from the date of approval (CDR) – asset classification which existed at time of **restructuring application**
- Mere extension of DCCO would not be considered as restructuring, if the revised DCCO falls within the period of one year from the original DCCO
- Change in repayment period is equal or shorter duration (including the start date and end date of revised repayment schedule) than the extension of DCCO

# Restructured Loans

Asset Classification benefits - classification not be downgraded if satisfactory performance during the specified period subject to:

- Dues being fully secured (other than SSI whose outstanding is less than 25 lakhs & Infrastructure projects having cash flows to repay advance through escrow mechanism)
- Unit becomes viable in 5 years (8 years for infrastructure cases)
- Repayment in 10 years (15 years for Infrastructure cases, not applicable to restructured housing loans, board to decide period)
- **Upfront** Promoter sacrifice and additional funding at least 20 percent of Bank Sacrifice or 2 percent of restructured amount whichever is higher
- Personal Guarantee of promoters
- Not a repeated restructuring
- Reschedulement of recovery cannot upgrade the classification from the previous classification

# Restructured Loans

- Fees and commissions earned by the bank as a result of re-negotiations or rescheduling of outstanding debts to be recognised on an accrual basis over re-negotiated period
- Provision to be made for the diminution in the fair value of the advance. Difference in present value of pre-restructured loan and post restructured loan. In case difficulty to calculate sacrifice, 5% of exposure where exposure is less than 1 crore
- Total provision should not exceed 100% of exposure
- Valuation and provisioning issues for equity, debt instruments received on restructuring. Debt and Equity to have same classification as restructured loan
- Norms for conversion of unpaid interest into FITL/ Debt/ Equity. Classification same as restructured advances.
- Unrealised income represented by FITL / Debt or equity instrument should have a corresponding credit in an account styled as "Sundry Liabilities Account (Interest Capitalization)"

# Challenges for Auditors

## Identification of Restructure accounts

- Obtain list of Accounts where there is change in repayment schedule/ rephasing or any other terms and conditions
- Obtain certified list of restructured account from Branch head

## Implementation of restructuring package without compliance with critical conditions like upfront promoters contribution

- Obtain CA certificate certifying compliance with critical conditions

## Some of the Banks classify the accounts as NPA on quarterly and not on day-to-day basis, Asset classification of which date should be considered?

- Irrespective of banks policy, identifying and classifying Asset classification for restructured accounts should be the date of classification

(E.g. Asset classification as on date of Application i.e. 08.06.2013 is SSA, Asset classification as on 30.06.2013-SA. In this case as account was SSA as on date of application the account should be classified as SSA upon restructuring)

# Challenges for Auditors

## **Compliances with periodic/subsequent restructuring conditions**

- Obtain compliance note shared by Lead Banker/MI with member bankers
- Obtain CA certificate certifying compliance with critical conditions

## **Ascertaining Viability of repayment**

- Critically review TEV study report
- Ascertain viability of projections made

## **Ascertaining Banks Sacrifice i.e NPV loss**

- Verify the system by entering dummy deal to ensure correctness of the system
- In case of manual calculation, check spreadsheet and formulas

## **What is retrospective restructuring?**

- Restructuring of an amount prior to the date of application of restructuring made by the borrower

# Challenges for Auditors

**Which Discounting rate should be applied for calculating Banks sacrifice?**

- Rate equal to the bank's BPLR or base rate (whichever is applicable to the borrower) as on the date of restructuring plus the appropriate term premium and credit risk premium for the borrower category **on the date of restructuring.**

**Lack of knowledge within the staff of the Bank**

- Ensure Proper training is given to staff who looks after restructuring
- Ensure competence of personnel handling restructuring cases

**Implementation within 120 days to avails quick implementation benefits**

- Certificate from branch head regarding compliance with all the conditions

# Challenges for Auditors

## **Non-Tagging of restructured accounts in System**

- Obtain certificate from Branch head that all the accounts restructured are tagged in system and no other account is restructured

## **Ensuring all credits in Escrow/TRA account**

- Obtain certificate from CA that all other bank accounts are closed



A white semi-truck is shown from a rear-quarter perspective, driving on a two-lane road. The scene is set during sunset or sunrise, with a bright sun low on the horizon to the left, creating a strong lens flare and illuminating the sky with orange and yellow clouds. The road surface is wet, reflecting the light from the sun. A large, semi-transparent orange rectangular box with rounded corners is overlaid on the right side of the image, containing the text "Other Key Points" in white. The truck's rear features a white trailer with multiple doors and latches, and a bumper with several lights.

# Other Key Points



# Income recognition

- Banks should not book income by way of **interest on NPA**
- However, interest on advances against **TD, NSCs, IVPs, KVPs (check for fraudulent documents) and Life policies** may be taken to income account on the due date, provided adequate margin is available in the accounts
- If Government guaranteed advances become NPA, interest on such advances **should not** be taken to income account unless the interest has been realised
- Verify whether Interest calculations are correct or not – sample basis and check systems also
- If any advance, including Government guaranteed, bills purchased and discounted, becomes NPA as at the close of any year, interest accrued and credited to income account in the past periods, should be reversed or provided for if the same is not realised

# Income Leakage

- The charges for sanction of loans as per the credit policy of the banks need to be verified and ensure recovery is proper (e.g. BG/LC commission, inspection charges, commitment charges, etc.)
- Recovery of proportionate processing fees at the time of renewal
- Penal interest on Stock and Debtors statement and QIS/FFR statements
- Penal interest on overdue balance as per agreed terms
- Penal interest on non-submission of papers for renewals
- Penal interest on non-creation of security related documents and charge with ROC

# LFAR

- Study the LFAR thoroughly with respect to advance portion
- Prepare the LFAR note for advances along with the statutory audit
- Give specific instances of shortcomings/ weaknesses in the advances sections
- Annexure to LFAR for large/ critical/ irregular accounts
- Critical comments affecting accounts should be part of main audit report and Qualified

# Statutory Restrictions

- Advances against Bank own shares - Sec 20(1) of B.R Act, 1949
- Advances to Banks Directors - Sec 20(1) of B.R Act, 1949
- Restriction on Holding Shares in Companies - Sec 19(2) of B.R Act, 1949
- Restriction on Credit to Companies for Buy-back of their Securities
- Granting Loans and Advances to relatives of Directors without prior approval of Board
- Restriction on payment of commission to staff members including officers- Sec 10(1)(b)(ii) of B.R Act, 1949
- Restriction on offering any incentives on any banking products- Master circular- DBOD.No.Dir.BC.14/13.03.00/2013-14 dated 01.07.2013
- Letter w.r.t notified S. 180(1)(c) of Companies Act, 2013 (erstwhile S. 293(1)(d) of the Companies Act, 1956)

# RBI Circular Reference

- Master Circular dated July 01, 2013 on IRAC Norms.
- Circular dated Feb 03, 2012 Housing Loan by Commercial Bank – Loan to value (LTV) ratio
- Circular dated Dec 20, 2013 on IRAC norms for Credit card accounts
- Master Circular dated July 01, 2013 - Bank Finance to Non-Banking Financial Companies (NBFCs)
- Master Circular dated July 01, 2013 - Interest Rates on Advances
- Master Circular dated July 01, 2013 - Lending to Micro, Small & Medium Enterprises (MSME) Sector
- Master Circular dated July 01, 2013 Lending to Priority Sector
- Circular dated Aug 26, 2013- Rupee Export Credit Interest Subvention

# Disclosure Requirements

- A)
  - i) Bills purchased and discounted
  - ii) Cash Credits, overdrafts and loans repayable on demand
  - iii) Term Loans
  
- B)
  - i) Secured by tangible assets
  - ii) Covered by bank/Government guarantees
  - iii) Unsecured
  
- C)
  - I. Advances in India
    - i) Priority sector
    - ii) Public sector
    - iii) Banks
    - iv) Others

# Disclosure Requirements

## II. Advances Outside India

- i) Due from banks
- ii) Due from Others
- iii) Bills purchased and discounted
- iv) Syndicated loans
- v) Others

Amount receivable from government of India under Agricultural Debt waiver scheme, 2008 should be separately under the head Term Loans, Unsecured and other in A, B and C respectively

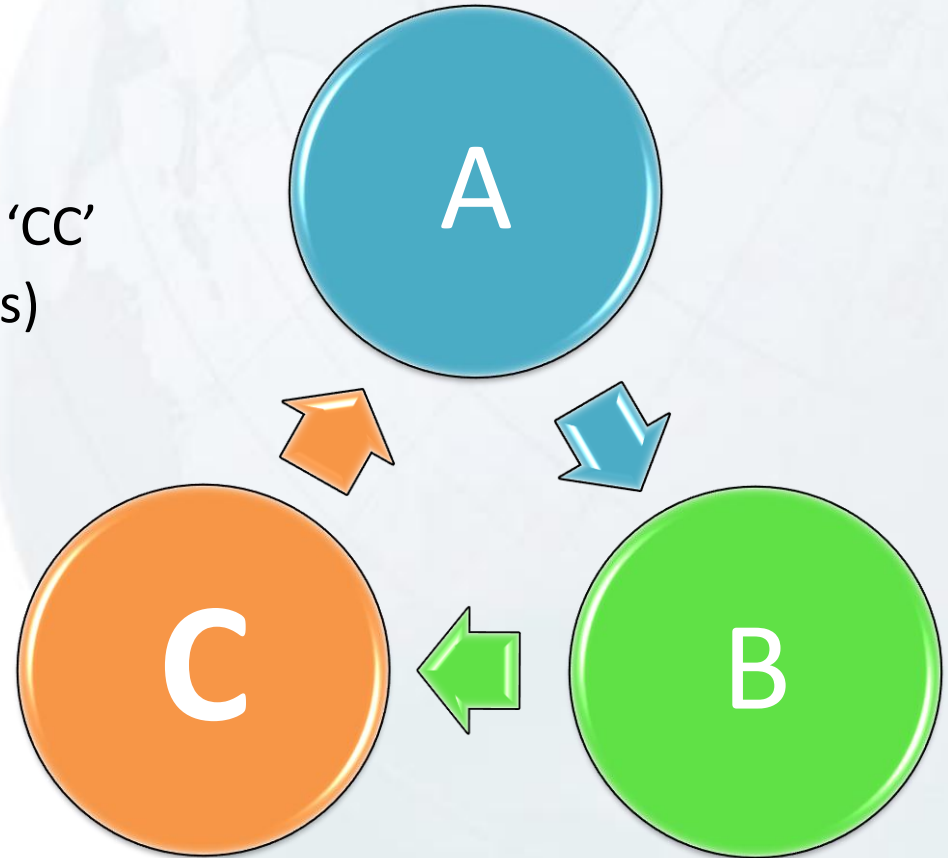
Maturity Analysis: 1day to 14 days, 14 days to 28 days, 29 days to 3 months, 3 to 6 months, 6 months to 1 year, 1 to 3 years, 3 to 5 years, more than 5 years

Segmental Analysis: Based on Wholesale and Retail

# Eye-opening Transactions

## Circuitous Transactions

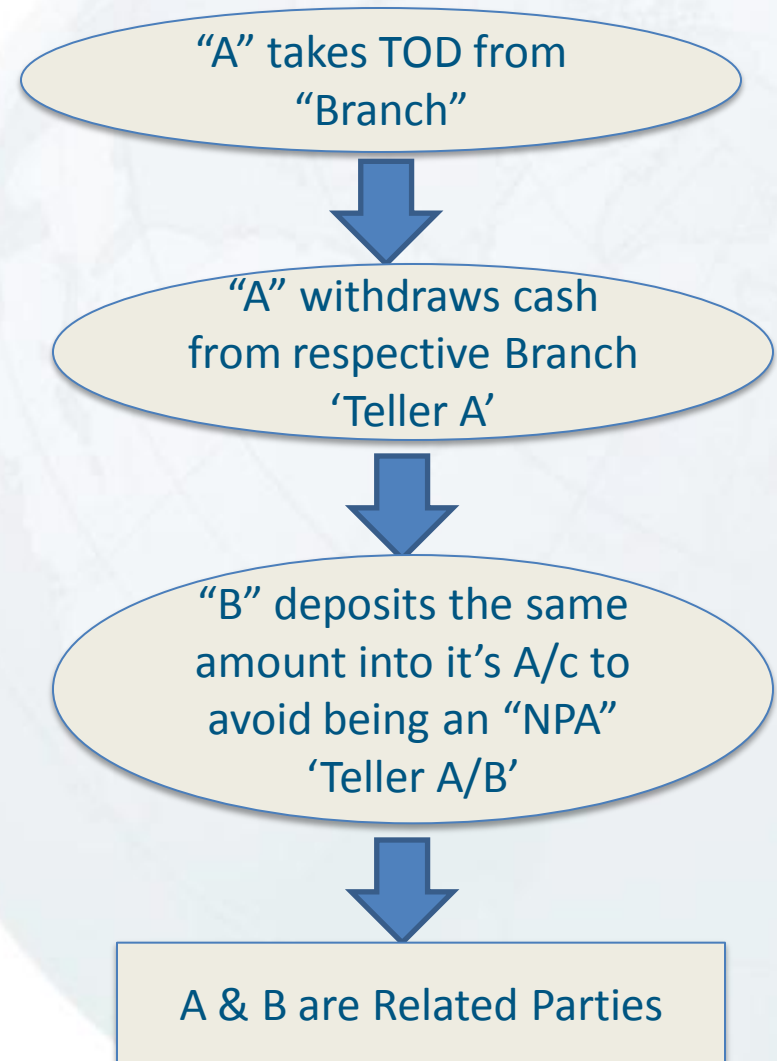
- 'A' takes TOD in Cash Credit (CC) account from Branch and transfers the amount to the Current (CA) account of 'B'
- 'B' transfers the amount to the 'CC' account of 'C' (no other transactions)
- 'C' serves its interest (no other transactions) and transfers the amount to CA account of 'A' which in turn transfers to its('A') CC account





# Eye-opening Transactions

## CASH CIRCUITOUS TRANSACTIONS



# Recent Case – First Leasing (Oct 13)

Farouk Irani, MD, admitted a hole of Rs.1,000 crore in its balance sheet

Assets worth only Rs.200 crore has been created, out of bank finance of more than Rs.1,200 crore

The Company requested former CBI Director R.K. Raghavan to conduct a forensic audit of its financial operations to ascertain if there has been any diversion of funds

In the light of the findings of the inspection of the books of accounts and other records as on March 31, 2013 , RBI directed the Co not to:

- Sell, transfer, create charge or mortgage or deal in any manner with its property and assets without prior written permission of the Reserve Bank of India;
- Declare or distribute any dividend;
- Transact any business; or
- Incur any further liabilities

# Recent Case: United Bank (Feb 2014)

- UBI posted net loss of Rs.1,238 Crore for the three months ended December 2013 with a quarterly interest income of Rs. 2766 Crore. Raising alarm, the lender's gross Non Performing Assets (NPAs) touched Rs.8,546 Crore during the same period as compared to Rs.2,964 Crore as at March last year
- Unlike giant borrowers like Kingfisher Airlines or Deccan chronicles, Bank has identified hundreds of accounts that turned bad aggregating Rs.2,300 Crore from smaller accounts below Rs. 10 lac
- An administrative enquiry is underway to find out why the lender's NPAs had been under-reported. Following a sharp surge in NPAs, the RBI has already ordered a forensic audit by a firm, which has submitted its report.
- SEBI – Corporate Governance, Insider Trading, Related Party Transaction
- ICAI is believed to be looking at the role of the bank's auditors
- Banks chairperson took VRS

# Recent Cases- Bank Frauds (Jan 14)

Public sector banks have cumulatively lost a massive sum of Rs.22,743 Crore due to cheating and forgery in the last three years alone, HT has found through a right to information (RTI) reply.

Indian Overseas Bank is the worst hit with a loss of Rs. 3,200 cores as against State Bank of India (SBI) which lost Rs.2,712 Crore

The number of fraud cases, for instance, came down to 2996 in 12-13 from 3748 in 10-11, but the amount shot up to Rs.10,180 Crore from Rs.3,275 Crore

As per the documents available, more than 6000 employees of different banks are under the scanner for involvement in these cases. These are not just lower or mid-level employees, but in some cases, CMDs and directors of different banks.

For Instance, in May 2013, a CBI special judge convicted M Gopalakrishnan, former Chairman-cum-Managing Director of Indian Bank, Chennai as he had sanctioned credit facilities of huge amounts to a company without sufficient securities and also by surpassing the rules of the bank.

Bankers sometimes exceed their discretionary powers and give loans to unscrupulous borrowers on fake or forged documents. After getting the money, the borrower escapes causing huge loses to the banks.

# Recent Cases – Co. op. Bank

Over Rs100 Crore jump in frauds in the last financial year

Amount involved has considerably increased from Rs612 Crore to Rs728 Crore

The increase in the fraud amount is largely attributable to a few high-value frauds in the loans and advances segment.

“It was further observed that in several cases, banks were either not reporting or reporting the fraud with undue delay. The actual amount involved (in fraud) could therefore be higher” said Nabard

# Recent Case- West Bengal Co Op Bank

In March 2013, the Bank lodged a complaint with Kolkata Police which stated that the bank lost Rs 60 crore in fraudulent transactions

Probe revealed that the co-operative bank was supposed to deposit Rs 60 crore in three different nationalized banks as fixed deposit but the money landed in the account of fraudsters.

The fraudsters, with the help of insiders, sent forged letters and gave another account number to the depositor that was created under a fictitious name.

# Recent Case – Mumbai District Co Op

Fake loans worth over Rs 60 crore were disbursed by Mumbai District Central Cooperative Bank in Kurla, with hundreds of people to whom the loans were purportedly given being unaware of the transactions.

At least 23 cooperative credit societies were involved in the loan fraud, as they had forged bonds and customer identification papers to get loans sanctioned from the bank.

The scam came to light in June last year, when around 400 residents of Asalfa in Ghatkopar and Kurla received letters from the bank asking them to repay loans they had never availed themselves of.

# Frauds- Statistics

## No. of Frauds cases reported by RBI regulated entities

(Rs. crore)

Category	No. of Cases	Amount Involved
Commercial Banks	169,190	29,910.12
NBFCs	935	154.78
UCBs	6,345	1,057.03
FIs	77	279.08
Total	176,547	31,401.01

## Year-wise no. and amount of fraud cases in the banking sector

(Rs. crore)

Year	No. of cases	Total Amount
2009-10	24,791	2,037.81
2010-11	19,827	3,832.08
2011-12	14,735	4,491.54
2012-13	13,293	8,646.00
Total frauds as of March 2013	169,190	29,910.12

Source: [www.rbi.org.in/scripts/BS\\_Speeches](http://www.rbi.org.in/scripts/BS_Speeches) (Frauds in the Banking Sector: Causes, Concerns and Cures- 29.07.2013)





# Questions???



*Thank you!*

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